Supreme Court, U. S.
FILED
SEP 23 1980

No. 79-1515

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

UNITED STATES OF AMERICA, *Petitioner,*

v.

ELWOOD SWANK AND RITA SWANK, *Respondents.*

UNITED STATES OF AMERICA, *Petitioner,*

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, *Petitioner,*

v.

BULL RUN MINING CO., INC.

On Writ Of Certiorari To The United States Court Of Claims

BRIEF OF ELWOOD SWANK AND RITA SWANK

LLOYD R. PERSUN
HOWELL C. METTE
SHEARER, METTE & WOODSIDE
1801 North Front Street
P.O. Box 729
Harrisburg, PA 17108
(717) 232-6701

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

QUESTION PRESENTED

Did the United States Court of Claims err in holding that Elwood Swank, as lessee, possessed an economic interest in certain coal in place under coal mining leases with Northumberland County, as lessor, which were not terminated during the years in suit, thereby permitting him to deduct allowance for percentage depletion of coal under Sections 611 and 613 of the Internal Revenue Code of 1954, as amended?

TABLE OF CONTENTS

PAGE

STATEMENT OF THE CASE 1

SUMMARY OF ARGUMENT 4

ARGUMENT 6

Swank Acquired An Economic Interest In The Coal In Place Mined Under His Coal Mining Leases With Northumberland County, And Is Entitled To A Percentage Depletion Deduction For Such Coal 6

A. Swank possessed economic interest in the coal in place 6

1. The acquisition of any interest in mineral in place by any form of legal relationship . 7

2. By investment 10

3. The securing of income derived from the extraction of the mineral and to which Swank must look for a return of his capital 12

B. Swank had an economic interest in the coal in place without regard to the term of the leases .. 13

1. The Swank leases were not terminated. The lessor agreed not to terminate the leases except for cause 13

2. Terminability is not an issue 17

C. Only Swank is entitled to percentage depletion and if denied this Congressional entitlement, no other person, including lessor, would be entitled to percentage depletion with respect to the coal mined by Swank 25

Conclusion 28

PREVIOUS PAGE WAS BLANK

TABLE OF AUTHORITIES

CASES: PAGE

Anderson v. *Helvering,* 310 U.S. 404 (1940) 8

Bakertown Coal Company, Inc. et al v. *United States,* 202 Ct. Cl. 842, 485 F.2d 633 (1973)..... 9, 12, 17, 19, 20, 21, 23, 25, 26, 27

Commissioner v. *Southwest Exploration Co.,* 350 U.S. 308 (1956)..... 8, 10, 12, 13, 14, 17, 20, 23, 24, 25, 27

Helvering v. *Bankline Oil Co.,* 303 U.S. 362 (1938)..... 24

Lynch v. *Alworth-Stephens Co.,* 267 U.S. 364 (1925)... 7, 9, 10, 12

Mullins v. *Commissioner,* 48 T.C. 571 (1967)..... 10, 23, 24

National Steel Corporation v. *U.S.,* 176 Ct. Cl. 952, 364 F.2d 375 (1966) 12, 13, 20

Palmer v. *Bender,* 287 U.S. 551 (1933)..... 4, 6, 7, 9, 10, 13, 17, 24

Paragon Jewel Coal Co. v. *Commissioner et al.,* 380 U.S. 624 (1965).. 5, 10, 11, 12, 17, 18, 19, 20-21, 25

Parsons v. *Smith,* 359 U.S. 215, 221 (1959) 6, 12, 17, 19, 20

Shenandoah Borough v. *Philadelphia,* 367 Pa. 180, 79 A.2d 433 (1951) 9

Swank v. *United States,* Ct. Cl., 602 F.2d 348 (1979) .. 9, 26

Thomas v. *Perkins,* 301 U.S. 655 (1937)..... 8-9

Thornberry Construction Co., Inc., 217 Ct. Cl. 196, 576 F.2d 346 (1978)..... 12, 23

Victory Sand and Concrete, Inc. v. *Commissioner,* 61 T.C. 407 (1977) 23

Weaver v. *Commissioner,* 72 T.C. 594 (1979) 23, 25

Table of Contents Continued

PAGE

Whitmer v. *Commissioner,* 28 T.C.M. 1480 (1960), affirmed 443 F.2d 1970 (3 Cir. 1971) 23, 24

Winters Coal Co., Inc. v. *Commissioner,* 496 F.2d 995 (5th Cir. 1974)..... 17, 23

CONSTITUTION AND STATUTES:

Internal Revenue Code of 1954, as amended (26 U.S.C.):

Section 611 ..... 24, 26

Section 613 26

Section 631 ..... 26, 27

MISCELLANEOUS:

Treasury Regulations on Income Tax (26 C.F.R.):

Section 1.611-1(b)(1) 4, 5, 13, 24

G.C.M. 26290, 1950-1 Cum. Bull. 42..... 20, 21, 23

Rev. Rul. 56-542, 1956-2 Cum. Bull. 327 20

Treas. Reg. 103, Section 19.23 (m)-(1)..... 24

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

UNITED STATES OF AMERICA, *Petitioner,*

v.

ELWOOD SWANK AND RITA SWANK, *Respondents.*

UNITED STATES OF AMERICA, *Petitioner,*

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, *Petitioner,*

v.

BULL RUN MINING CO., INC.

On Writ Of Certiorari To The United States Court Of Claims

BRIEF OF ELWOOD SWANK AND RITA SWANK

STATEMENT OF THE CASE

The termination clauses in the leases involved in this case were never exercised.

Pursuant to a deep mining lease dated October 24, 1964, Swank,[1] as lessee, deep mined anthracite coal

---

[1] References to Swank are to Respondent Elwood Swank. Rita Swank is a party solely because she filed joint federal income tax returns with her husband during the years in suit.

from 1964 through 1967. Pursuant to a stripping lease dated July 25, 1966, Swank, as lessee, strip mined anthracite coal during 1966 and 1967. The lessor under these mining leases was Northumberland County. The lessor never terminated the leases. Swank's successor, Split Vein Coal Company, Inc.,[2] is still mining pursuant to the stripping lease. The 1964 deep mining lease was abandoned in May 1968 because of a mountain slide caused by heavy rains which closed the deep mine, thereby preventing further mining of the mine by anyone. Swank and his successor, Split Vein Coal Company, Inc., deep mined coal under the deep mining lease until the mountain slide closed the mine (J.A. 51a-52a).

Swank purchased the October 24, 1964 deep mining lease, and the mining operation thereunder, from Edward Gusick who owned and mined under the lease before Swank. The purchase price was $12,085, which allocated as follows: $5,085 for generating equipment and $7,000 for Gusick's existing excavation and mine (J.A. 52a, 55a).[3]

Swank did not negotiate or prepare the leases. He could not do so. These leases were on standard forms prepared and used by the County of Northumberland. The leases were not subject to negotiation. Nor-

---

[2] During 1966 and the first four months of 1967, Swank was a sole proprietorship. On May 1, 1967, the assets of the sole proprietorship were transferred to Split Vein Coal Company, Inc., in a tax-free incorporation pursuant to Section 351 of the Internal Revenue Code of 1954, as amended.

[3] The government contended before the Court of Claims that only $1,000 of the purchase price was capitalized into an account covering purchased excavations. However, the Learned Trial Judge and the Court of Claims rejected this contention (J.A. 52a; 602 F.2d at 350, 352), finding that Swank purchased the excavation for $7,000.

thumberland County never sold a fee simple interest in coal lands for fear of criticism over selling such land if valuable minerals were discovered subsequent to sale. The Northumberland County Commissioners told Swank that Northumberland County would not terminate his leases except for cause. The commissioners also announced this policy not to terminate mining leases except for cause in public meetings and in the press. Every lessee of county coal lands received the same form lease from the county and in each case it was with the stipulation that the county would not terminate except for cause. The reason for this policy was that the County Commissioners recognized that they could not expect a lessee of county coal land, like Swank, to invest time and considerable capital in the development of county coal lands without some assurance that, if he conformed to the terms of the lease, he would be allowed to recover his investment and make a profit on his mine (J.A. 53a-55a).

The Northumberland County Commissioners terminated mining leases only for cause, which meant:

(1) Failure to pay the royalties; or

(2) Failure to pay the correct amount of royalties; or

(3) Failure to make the mine productive (J.A. 54a).

The Swank leases contain no express language permitting Northumberland County to terminate the leases "without cause". The words "without cause" are not in the leases (J.A. 22a-48a).

Swank was under no obligation to sell the coal to Northumberland County or any other party or person. He sold the coal to whomever he pleased at whatever price he could obtain. Swank sold no coal to Northumberland County (J.A. 54a).

The income which Swank received from his mining operations was solely derived from, and tied to, his extraction and sale of coal during the tax years involved. Swank looked solely to the extraction of coal for a return of his investment (J.A. 52a-55a). Swank was not a mining contractor. He was a coal miner mining coal as a lessee under valid coal leases (J.A. 51a, 55a).

Swank's investment in the coal in place was substantial. Swank invested more than $225,000 in strip mining and deep mining equipment. He purchased and improved a tipple, or breaker, at a cost of $118,477.27; constructed a railroad siding at a cost of $10,000; and built access roads to his strip mine from public highways at a cost of $6,500. In addition, during 1966 and 1967, Swank's payroll consisted of 14 employees, and he paid Northumberland County royalties of $7,545.10 in 1966 and $6,854.05 in 1967 (J.A. 53a, 55a-56a).

SUMMARY OF ARGUMENT

By his leases with Northumberland County, Swank acquired an economic interest in the coal in place. In order to mine, process and market the coal conveyed to Swank under the leases, Swank invested more than $325,000 to purchase mining machinery and equipment, to purchase and improve a tipple, to purchase a railroad siding and also to build roads for access to public highways from his strip mine. Swank owned the coal he extracted under the leases. He sold it to whomever he wanted at the best price he could obtain. Swank looked not to the lessor but to the extraction and sale of the coal for return on his investment and profit. Therefore, Swank satisfied the requirements of the economic interest test established by this Court in *Palmer* v. *Bender*, 287 U.S. 551 (1933) and adopted almost *verbatim* by Petitioner in its Treasury Regulations. Treas. Reg. 1-611-1(b)(1).

Swank had an economic interest in the coal in place without regard to the term of the leases. Swank's leases were not terminated. Northumberland County, the lessor, agreed not to terminate the leases and did not do so. During the tax years in question, Swank mined continuously under the leases. Petitioner ignores this reality.

Terminability is not an issue. Petitioner's argument is based upon the possibility that the leases might have been terminated. Terminability is only one of seven criteria, applicable only to mining contractors, not lessees like Swank. These seven criteria are used only in mining contractor cases to determine whether mining contractors qualify for percentage depletion. Unlike mining contractors, Swank by his leases with Northumberland County acquired the right to mine the coal and to convert the mined coal to his own use. This right, coupled with his investment and his looking to extraction and sale of the coal, and not to the lessor, for a return of his investment and profit, differentiates Swank and other lessees of coal property from mining contractors. *Paragon Jewel Coal Co.* v. *Commissioner,* 380 U.S. 624 (1965).

Only Swank is entitled to percentage depletion and if denied this Congressional entitlement, no other person, including lessor, will be entitled to percentage depletion with respect to coal mined by Swank. The lessor is relegated to capital gains treatment on the rents or royalties received from the lessee and must use cost depletion in computing the capital gains. The lessee deducts the percentage depletion allowance from ordinary income derived from the sale of coal mined under the leases, excluding rents and royalties paid to the lessor. Petitioner confuses percentage depletion and cost depletion. Percentage depletion, not cost depletion, is involved in this case.

ARGUMENT

Swank Acquired An Economic Interest In The Coal In Place Mined Under His Coal Mining Leases With Northumberland County, And Is Entitled To Percentage Depletion Deduction For Such Coal

A. Swank possessed an economic interest in the coal in place

A prerequisite to the allowance of the percentage deduction is the existence in the claiming taxpayer of an economic interest in the coal in place, the definition of which interest was first described in *Palmer* v. *Bender,* 287 U.S. 551 (1933), and later incorporated almost *verbatim* into Treasury Regulation §1.611-1(b)(1), which provides in pertinent part as follows:

> "An economic interest is possessed in every case in which the taxpayer has acquired by investment *any* interest in mineral in place or standing timber and secures, by *any form* of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital."(Emphasis added)

Accord, 287 U.S. at 557; *Parsons* v. *Smith,* 359 U.S. 215, 221 (1959).

This regulation defines the elements of an economic interest, and also describes the exact nature of Swank's interest in the coal under his leases with Northumberland County. These elements are as follows:

> (1) An acquisition of any interest in mineral in place by any form of legal relationship,
>
> (2) By investment, and
>
> (3) The securing of income derived from the extraction of the mineral and to which the taxpayer must look for a return of his capital.

1. The acquisition of any interest in mineral in place by any form of legal relationship

The 1964 deep mining lease and the 1966 stripping lease were entered into by Northumberland County, as lessor, and Swank, as lessee. The deep mining lease granted Swank "the right and privilege of digging and mining anthracite coal wholly at his own expense and cost" from the Jeremiah Jackson tract of land and the Fulton Lands in Northumberland County (J.A. 23a). The 1966 stripping lease granted Swank the "right to have, convey and transport the raw coal stripped from the said premises over, through and across the . . . premises", at "his own expense and cost" (J.A. 42a-43a).

There is no contention that these leases were not valid and binding upon the parties thereto during the tax years in question. Where there is a valid and binding lease of coal, there is a sufficient "form of legal relationship". *Palmer* v. *Bender, supra.* The economic interest of the lessee exists independently of the lessor's legal title to the mineral in place. *Lynch* v. *Alworth-Stephens Co.,* 267 U.S. 364 (1925), wherein the Court ruled:

> "It is, of course, true that the leases here under review did not convey title to the unextracted ore deposits *(United States* v. *Biwabik Mining Co.,)* 247 U.S. 116, 123, 38 S. Ct. 462, 62 L. Ed. 1017); but it is equally true that such leases, conferring upon the lessee the exclusive possession of the deposits and the valuable right of removing and reducing the ore to ownership, created a very real and substantial interest therein. See *Hyatt* v. *Vincennes Bank,* 113 U.S. 408, 416, S. Ct. 573, 28 L. Ed. 1009; *Ewert* v. *Robinson,* 10 Cir., 289 F. 740, 746-750. And there can be no doubt that such an interest is property. *Hamilton* v. *Rathbone,* 175 U.S. 414,

421, 20 S. Ct. 155, 44 L. Ed. 219; *Bryan* v. *Kennett,* 113 U.S. 179, 192, 5 S. Ct. 407, 28 L. Ed. 908.

* * *

"There is nothing to suggest that the word 'property' is used in any restricted sense. In the case of mines, a specific kind of property, the exhaustion is described as depletion,. . .The interest of respondent under its leases in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year results from the plain terms of the statute, such deduction, since the property is an interest in mines, to be limited to the amount of the exhaustion of respondent's interest caused by the depletion of the mines during the taxable year.

* * *

It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent [a lessee] does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision." 267 U.S. at 369-370.

Similarly, in *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308 (1956), the Court recognized "that the law of depletion requires an economic rather than a legal interest in the oil [mineral] in place". 350 U.S. at 316.

In *Anderson* v. *Helvering,* 310 U.S. 404 (1940), the Court discussed the requirements of the "form of legal relationship." The Court noted that, in *Thomas* v.

Perkins, 301 U.S. 655 (1937), a provision in an oil lease for payments solely out of oil production was equivalent to a reservation from the granting clause of an amount of oil to the grantor, and should be given the same tax consequences as a provision for oil royalties. Citing *Palmer* v. *Bender, supra,* the Court stated that the *Perkins* decision, "did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type." 310 U.S. at 411. The lessee's right under his lease to convert the lessor's legal title to minerals in place to his own possession by their severence constitutes a very real and substantial economic interest in the mineral in place which depletes as the minerals are extracted. *Lynch* v. *Alworth-Stephens Co.,* 267 U.S. at 369; *Swank* v. *United States,* _____Ct. Cl. _____, 602 F.2d 348, 353-354 (1979); *Bakertown Coal Company, Inc. et al.* v. *United States,* 202 Ct. Cl. 842, 485 F.2d 633 (1973).

Under Pennsylvania law, a lease of coal lands constitutes a sale of the coal by the lessor to the lessee. *Shenandoah Borough* v. *Philadelphia,* 367 Pa. 180, 79 A.2d 433 (1951), wherein the Pennsylvania Supreme Court emphasized:

> "To a great many people who do not live in coal counties, the aforesaid instrument having the usual terms and attributes of a lease, would seem to be a lease. Nevertheless, the law is long and well settled in Pennsylvania that ' "The grant of a right to mine coal in the lands of the lessor and remove it therefrom, although the instrument may be called a lease, is a grant of an interest in the land itself, and not a mere license to take the coal." The transaction. . . constituted a sale of the coal conditioned upon its being removed within the period specified':

> *Lazarus's Estate,* 145 Pa. 1, 8, 23 A.372." 367 Pa. at 186, 79 A.2d at 436.

Therefore, there is no question that, as a matter of law, a substantial ownership interest in the coal was vested in Swank under his leases with Northumberland County. *Palmer* v. *Bender, supra; Lynch* v. *Alworth-Stpehens Co., supra.*

2. By Investment

In *Commissioner* v. *Southwest Exploration Co., supra,* the Court explained the investment requirement:

> "An allowance for depletion has been recognized in our revenue laws since 1913. It is based on the theory that the extraction of minerals gradually exhausts the capital in vestment in the mineral deposit. Presently, the depletion allowance is a fixed percentage of gross income which Congress allows to be excluded; this exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired. *The present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment on his original investment. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit.* The depletion allowance in the Internal Revenue Code of 1939 [the forerunner of the present statute] is *solely* a matter of *Congressional grace; . . .*" 350 U.S. at 312 (Emphasis added).

Accord, *Paragon Jewel Coal Co.* v. *Commissioner et al.,* 380 U.S. 624 (1965); *Charles P. Mullins* v. *Commissioner,* 48 T. C. 571, 579-580 (1967) (two leases held to confer economic interest in lessee despite lessee's not investing any money in the coal deposit).

Paragon Jewel involved a dispute over entitlement to coal depletion allowance between lessee under an assignment of coal leases and the mining contractors hired by the lessee to mine the coal. The Court held that Paragon Jewel, the lessee, was entitled to the depletion allowance, finding the following purchases by Paragon Jewel to be an investment within the meaning of Treasury Regulation 1.611-1(b)(1):

> "It [Paragon Jewel, the lessor] made substantial investments in preparation for processing and marketing the coal, including construction of a tipple, a power line, a railroad siding with four spurs and the purchase of processing equipment. It also built a road from the tipple which circled the mountain close to the outcrop line of coal. This road was used to truck coal from the contractors' mines to Paragon's tipple." 380 U.S. at 628.

Similarly, in order to mine under the leases and to process and to market the coal, Swank purchased machinery and equipment at a cost exceeding $225,000 (J.A. 56a) and constructed roads at the strip mine as access to public highways for a total cost of $6,500 (J.A. 55a). Swank also maintained, at his expense, his own breaker, or tipple, which is a plant required to clean and to process the coal. In 1959, he purchased the tipple for $22,000. Between 1959 and 1966 he spent $96,477.27 to make improvements to the tipple, which were necessary to make it operable. Swank operated this tipple during the tax years in question (J.A. 56A). In 1962 or 1963, he purchased for $10,000 a 600-foot railroad siding located 1,000 feet from his tipple. The siding was connected to the Penn Central rail line and, during the years in suit, was used to transport coal to the public after its sale from Swank's tipple. He leased the land where the siding was located in 1966 and 1967 for $600 per year (J.A. 56a). Swank also purchased two leases and in-

dependent mining operations for $19,085. These purchases included slopes or excavations several hundred feet deep and also certain mining equipment in the mines (generator, hoist, pump compressor, rails for access by buggie to the mines) (J.A. 52a). Swank paid Northumberland County $14,339.15 in royalties under the leases during 1966 and 1967 (J.A. 53e). As a matter of law, these expenditures constitute an investment sufficient to establish Swank's economic interest in the coal in place. *Commissioner* v. *Southwest Exploration Co., supra; Paragon Jewel, supra; Thornberry Construction Co., Inc.*, 217 Ct. Cl. 196, 576 F.2d 346 (1978); *Bakertown, supra; National Steel Corporation* v. *U.S.*, 176 Ct. Cl. 952, 364 F.2d 375 (1966).

Another factor militates in Swank's favor. Northumberland County, a municipal government, neither claimed nor needed to claim the depletion allowance at bar. Unless Swank prevails, no one will be entitled to and no one will receice percentage depletion allowance on the coal removed from the land under the leases during the years at issue. Congress clearly did not intend this result, as the Court noted in *Lynch* v. *Alworth-Stephens Co.* and *Parsons* v. *Smith, supra.* Accord, *Bakertown, supra.*

3. The securing of income derived from the extraction of the mineral and to which Swank must look for a return of his capital.

That income was derived from Swank's coal mining operation under the leases is not disputed. The critical point is that such income resulted solely from porfits realized by the sale of the coal in the market place. Swank owned the coal which he removed. He was under no obligation to sell the coal to lessor or anyone else.

He could sell the coal to whomever he pleased at whatever price he could obtain. He did so (J.A. 54a). There is no provision in either lease for any payment by the lessor to the lessee which would indicate any agency relationship. (J.A. 22a-48a). Petitioner does not dispute these facts.

Any income accruing to Swank was as a result of the dissipation or depletion of coal owned by him, and the offsetting depletion allowance should rightfully be available to him. Swank, as lessee, was mining coal for sale to a third party, not lessor, at an independently determined price, and was required to look to the extraction of that coal and the sale thereof for a return on his investment and profit. The income and extraction element of Treasury Regulation 1.611-1(b)(1) and *Palmer* v. *Bender, supra,* is, therefore, satisfied.

B. Swank had an economic interest in the coal in place without regard to the term of the leases.

1. The Swank leases were not terminated. The lessor agreed not to terminate the leases except for cause.

Petitioner based its disallowance of Swank's depletion deduction on its contention that the printed lease forms required by Northumberland County entitled the lessor to terminate the lease without cause on thirty-day's notice.[4] The gravamen of Petitioner's argument is the *possibility* that the leases might have been terminated. With respect to depletion, the tax law deals in economic realities, and not in possibilities or bare legal abstractions or fictions. *Southwest Exploration, supra,* 350 U.S. at 315; *National Steel, supra,* 176 Ct.

---

[4] Petitioner's Brief at 16-23.

Cl. at 967, 364 F.2d at 383. The *reality* at bar is that, during the tax years in question, the leases were not terminated and that, pursuant to the leases, Swank mined coal during the tax years in question (J.A. 52a-54a). Swank's successor, Split Vein Coal Company, Inc., is still strip mining under the July 25, 1966 strip mining lease.

In *Southwest Exploration,* the Court was required to determine whether the upland land owners or the drilling contractor was entitled to the oil depletion allowance. The land of the upland property owners was indispensable to the drilling. The drilling contractor, Southwest, argued that drilling approaches which it might have used in compliance with California law qualified it for the oil depletion allowance. In rejecting this argument, the Court emphasized:

> "State law required that the wells be drilled either on the uplands or on filled lands, and there were no filled lands available. By hindsight Southwest now suggests that it might have constructed a drilling island which might have been considered as filled land under the statute. Then, too, perhaps the State itself might have changed the law or condemned the uplands under existing law. But none of these possibilities occurred." 350 U.S. at 315-316.

The Court based its decision in *Southwest Exploration* on the facts which actually occurred, not on speculation about unrealized possibilities.

The termination provisions of Northumberland County coal leases were unusual. Despite the termination provisions, the County Commissioners, since 1956, promised Swank and the other Northumberland County miners that the leases would be terminated only for cause (J.A. 54a-55a). Cause was defined as: (1) failure to pay the royalty; (2) cheating the lessor on the amount

of the royalty; or (3) failure to mine for an unreasonable period of time. Swank discussed these causes and the termination provision with the County Commissioners before signing the leases (J.A. 54a-55a). The County Commissioners recognized that they could not expect Swank or any other miner to invest time and considerable capital in development of mines under the leases without assurance that, if he conformed to the terms of the lease, he would be allowed to recover his investment and make a profit on his mines (J.A. 54a). The termination provisions of the leases contained no reference to the words" without cause" (J.A. 22a-48a).

The leases were standard forms with "boilerplate" clauses prepared by the County of Northumberland, not Swank, and were not subject to negotiation (J.A. 53a-54a). Swank, if he wished to mine in the Shamokin area where he lived, was required to sign the leases with only the oral stipulation that the leasees would not be terminated except for cause. Every miner received the same lease form (J.A. 54a). Consequently, Swank did not enter into the leases in an arms-length, fully negotiated transaction. He had no alternative! The Court of Claims described such leases as " 'administered' leases" (J.A. 53a-54a).

The Northumberland County Commissioners would not enter into leases without a 30-day termination clause, in order to avoid allegations of political favoritism in granting long-term coal leases to friends or criticism by the public in leasing county coal lands. This policy was publicly announced in Northumberland County since 1956. The Northumberland County Commissioners never sold a fee simple interest in the coal lands in order to avoid criticism over selling such lands if valuable, extensive coal deposits were discovered and

exploited by the purchaser after the sale (J.A. 53a). Instead, Nortnumberland County, as lessor, acting through its Commissioners, collected coal royalties from the lessee-independent coal miners who mined these coal lands. The royalties were used to finance Northumberland County government, without the County's having to become engaged in coal mining. The county's objective was to keep the lessees' mines actively producing and to collect royalties from the lessees' coal mining operations without having to engage in coal mining and without disposing of the valuable coal lands purchased at tax sales (J.A. 53a-54a).

Undoubtedly, any miner dealing with the County would like to have a long-term lease. A miner dealing with a private owner of coal-bearing land might well negotiate a long-term lease before proceeding. But independent miners take what the County will give where the County has a virtual monopoly on coal-bearing land. Northumberland County will not sell land, and its standard lease must be accepted by all who wish to mine on county land.

Northumberland County is located in the heart of the anthracite deposits in the United States. These deposits are concentrated in north central Pennsylvania. During 1966 and 1967, the County owned more than 17,500 acres of anthracite coal land which it leased to miners like Swank under leases identical to Swank's leases (J.A. 52a, 54a). By depriving Swank the percentage depletion allowance for coal mined under the leases, the Court establishes precedent denying percentage depletion for coal mined throughout Northumberland County — a significant portion of the nation's anthracite deposits. This result violates Congressional policy underlying the percentage depletion

allowance — because mineral deposits are wasting assets, the percentage depletion is available to the owner of an economic interest therein so long as the minerals are extracted even though no money is invested in the deposits. This policy is based upon Congress' legislative grace. *Palmer* v. *Bender, supra; Southwest Exploration, supra.*

2. Terminability is not an issue

Petitioner's entire argument is predicated on its misapprehension that seven factors, applicable only to mining contractors, are also applicable at bar. These seven factors were listed in *Parsons* v. *Smith, supra,* and *Paragon Jewel Coal Co.* v. *Commissioner, supra.* Your Honorable Court, the Fifth Circuit Court of Appeals and the Court of Claims expressly ruled that these factors apply *only to mining contractors. Paragon Jewel, supra; Winters Coal Co., Inc.* v. *Commissioner,* 462 F.2d 995 (5th Cir. 1974); *Bakertown, supra; Thornberry, supra.* Swank is *not* a mining contractor; Swank *is* a coal miner, a lessee of coal lands (J.A. 55a).

In *Parsons* and *Paragon,* the Court illustrated the distinction between lessees of coal lands and mere mining contractors. By the lease, the lessor surrenders to the lessee or sublessee part of the lessor's interest in the coal in place. Under the lease, the lessee, after severing the coal from the leasehold, owns the coal and sells the coal to whomever the lessee pleases at whatever price he can obtain. The lessee derives income from the sale of the coal, to which he must look for a return of his capital. In comparison, by his contract to mine, the mining contractor enjoys no interest in the coal after severence, which coal belongs to the lessee or landowner, and the mining contractor looks only to the

lessee or the landowner for payment of a fixed price per ton of coal mined under the contract. The *Paragon* Court explained the seven factors applicable to contract miners:

> "In *Parsons,* the Court enumerated seven factors to be considered in determining whether the *coal-mining contracts* there involved gave the *contract miners* any capital investment or economic interest in the coal in place" 380 U.S. at 633. (Emphasis added.)

In *Paragon,* which involved a dispute between a lessee and its mining contractor over percentage depletion allowance, the Court held that the lessee, Paragon, not the mining contractor hired by the lessee, qualified for the percentage depletion allowance, explaining:

> "Section 611(b) establishes an equitable apportionment of such allowance between the lessor and the lessee in the case of a lease. However, §611(b) must now be read in the light of §631(c) which provides that an owner who disposes of coal under any form of contract in which he retains an economic interest shall not receive percentage depletion, but instead must take capital gains treatment for the royalties received under that contract. The result of this in the typical lessor-lessee situation is that the lessee is entitled to the entire depletion allowance on the gross income from the property. Respondent contract miners make no contention that they are lessees or the sublessees of Paragon." 380 U.S. at 632-633.

Crucial to the *Paragon* Court's denying the contractor's claim for percentage depletion deduction was that they had not acquired an interest in the coal in place and had not secured income from the extraction of the coal. Instead, they had to look only to the lessee's covenant for payment of the agreed upon fee regardless of the market price at the time the coal was delivered. 380 U.S. at 635.

In *Parsons* and *Paragon*, the Court applied the seven factors to contract miners only, not to lessees under coal leases. Throughout its brief,[5] Petitioner, erroneously, uses the terms "lessee" and "mining contractor" as synonyms. The *Parsons* and *Paragon* Courts distinguished between the terms, applying the seven factors only to mining contractors. Consequently, terminability, only one of the seven factors, is inapplicable to coal leases and the economic interests of lessees in the coal in place described therein.

The *Bakertown* Court similarly concluded:

> ". . . [I]n view of the Government's total preoccupation with the matter of terminability, we think its position in this case is the product of confusion in the economic interest area of depletion. In our view, the entire defense herein rests on a misapplication of basic principle.
>
> "It seems to us that the Government is here attempting to remove transactions from the traditional ambit of economic interest by resort to a principle [the seven factors applicable to mining contractors only as announced in *Parsons, supra*] that it sponsored to liberalize and expand that established concept to encompass transactions not therefore within it. The erroneous transposition is as between lessees, persons who have acquired the right to remove and retain mineral underlying the leased premises, and mining contractors who, although functionally involved in the production of salable mineral (and therefore financially interested in the life of the deposlt as a source of continuing need for their services), have no effective authority over production and acquire no ownership of the extracted mineral. 202 Ct.Cl. at 848, 485 F.2d at 636.

---

[5] Petitioner's brief at 16-23.

* * *

"In sum, it appears that the pertinence of the terminability factor [*one* of the seven factors] as advanced by the Treasury, was as a device for enlarging the concept of economic interest in order to afford strip miners, who had no fee or leasehold interest, the benefits of depletion deductions to offset the income that they earned in the form of fees for their extraction services. 202 Ct.Cl. at 851, 485 F.2d 638.

In 1950, the Treasury Department created terminability as a device to enlarge the economic interest concept to afford contractors, who, unlike Swank, lacked a fee or leasehold interest, the benefits of percentage depletion deduction. Research reveals that, before 1950, the United States Supreme Court never found a taxpayer to have a depletion interest in a mineral deposit without a fee or leasehold interest in that deposit.[6] For this reason, the Treasury Department compromised to benefit mining contractors, promulgating G.C.M. 26290 (1950-1 Cum. Bull. 42).[7] *Bakertown, supra.* G.C.M. 26290 listed terminability as *one* of *seven* criteria to consider in determining the availability of the depletion allowance for *contractors.* Terminability is not the only such criterion. *Parsons v. Smith, supra; Paragon Jewel*

---

[6] Research also reveals that, since then, the United States Supreme Court only once held that a taxpayer without a fee or leasehold interest in the deposit was entitled to depletion. *Southwest Exploration, supra* (1956) (Upland property owners were found to have an economic interest in offshore oil deposits extracted by slant drilling because the use of their property was physically and legally indispensable to the extraction process.)

[7] In 1956, Treasury extended depletion allowance to a mining company's shareholders for mineral deposits owned by the company. Rev. Rul. 56-542, 1956-2 Cum. Bull. 327. See, *National Steel Corp.* v. *United States, supra.*

Coal Co. v. *Commissioner, supra.* These cases and the other cases on which Petitioner relies, improperly, are mining contractor cases. Swank was a coal miner with leasehold interests pursuant to which he mined in 1966 and 1967, the years in suit. The leases were not terminated during that time. Speculate as it will, Petitioner cannot escape these facts. In *Bakertown,* the Court of Claims stressed the defects in Petitioner's argument:

> "Though terminability was one of the seven disqualifying factors mentioned, it cannot be considered either in isolation or in the abstract, as the Government would have it. Rather, it is clear that in the context of the contractor-oriented opinion coming in the wake of G.C.M. 26290 and the decisions that followed it, the matter of terminability becomes only a colorably relevant factor where the applicant for the allowance lacks the traditional qualifications for depletion, as reflected by the other six conditions referenced by the court.
>
> * * *
>
> "In the context of economic interest, terminability has been specifically considered by the Supreme Court only in the evaluation of depletion claims by mining contractors." 202 Ct.Cl at 853-854, 485 F.2d at 639-640.

By its express terms, G.C.M. 26290 referred *only* to *contractors.* G.C.M. 26290 created seven (7) criteria applicable only to contractors for the purpose of enabling contractors, who mined only for the benefit of landowner coal company-landowners or lessees for sums due them from removing the coal, to claim the percentage depletion allowance. If, in a particular case, the contractor qualifies for the depletion allowance, the landowner coal company or lessee cannot claim it. The contractors, unlike Swank, are not able to convert the

coal to their own use by severing or mining it. The contractor, unlike the lessee, owns no coal, even after severance. The landowner coal company or lessee owns all the coal mined by a contractor. At bar, when Swank mined the coal under the leases, he owned it; sold it to whomever he pleased at whatever price he wanted; never sold it to Northumberland County; and did not look to the County for any income from his mining the coal. Swank was entitled to receive and received all proceeds from the sale of the coal.

The Court of Claims explained Petitioner's misconception that terminability applies to lessees under mining leases:

> "The erroneous transposition is as between lessees; persons who have acquired the right to remove and retain mineral underlying the leased premises, and mining contractors, who although functionally involved in the production of salable minerals (and therefore financially interested in the life of the deposit as a source of continuing need for their services), have no effective authority over production and acquire no ownership of the extracted mineral." 202 Ct. Cl. at 848, 485 F.2d at 636.

Petitioner does not dispute that the leases are bona fide mineral leases or that, while in force, the leases gave Swank automonous authority over the extraction and sale of the underlying coal. Swank had complete title to the coal he removed and could sell it to whomever he wanted at whatever price he could obtain. Swank looked to extraction of the coal and its sale for his return on investment and profit. He was not required to deliver any coal to lessor at a fixed or fee per ton. The leases were not terminated during the years in suit. These *facts,* which are undisputed, control. Irrelevant are Petitioner's

conjectures about what might have occurred at a different time if the leases had been cancelled or terminated for whatever reason. *Southwest Exploration, supra,* 350 U.S. at 315-316.

Petitioner erroneously characterizes the decisions of the Court of Claims in *Bakertown* and its progeny as a minority view which misconceives the "economic interest" test.[8] In support of this characterization, Petitioner cites contract miner cases which, because of G.C.M. 26290, consider the seven (7) criteria in determining whether or not to allow the percentage depletion deduction to mining contractors. The only cases cited by Petitioner which involve lessees with leasehold interests claiming depletion deduction were decided by the Tax Court. *Winters Coal Co.* v. *Commissioner,* 57 T.C. 249 (1971), *reversed* 496 F.2d 995 (5th Cir. 1974); *Whitmer* v. *Commissioner,* 28 T.C.M. 1480 (1960), *affirmed* 443 F.2d 1970 (3 Cir. 1971); *Charles P. Mullins* v. *Commissioner, supra.* The lessee cases which sustain Swank's position are equally numerous. *Bakertown, supra; Thornberry, supra; Winters Coal Co., supra* (Fifth Circuit Opinion). The Tax Court in *Victory Sand and Concrete, Inc.,* 61 T.C. 407 (1977) even declined to apply the so-called terminability rule. In *Lloyd Weaver,* 72 T.C. 594 (1979), the Court held that a lease terminable on 120-days' notice without cause provided the lessee thereunder with an economic interest in the coal in place. In that case, the Tax Court questioned and criticized *Whitmer* and expressly declined to extend the terminability doctrine, despite Petitioner's urging the Court to do so. 72 T.C. at 607-609. Petitioner did not appeal *Weaver,* and the appeal period expired.

---

[8] Petitioner's brief at 19-22.

Petitioner frequently cites *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362 (1938) and *Southwest Exploration, supra.* There is no mention of terminability in the opinions in these cases. The *Bankline* Court even noted that the taxpayer "had no interest as lessor or lessee or as sub lessor or sublessee, in any of the producing wells." 303 U.S. at 366.

The "economic interest" language of Treasury Regulations Section 1.611-1(b) was adopted almost literally from the language of the opinion in *Palmer* v. *Bender, supra,* and has remained virtually unchanged since the regulations on this subject were first issued under the Internal Revenue Code of 1939 (Treas. Reg. 103, Section 19.23(m)-(1). These regulations have never contained any provision, or even a suggestion, of a requirement of non-terminability in order for a lessor or a lessee to be entitled to his equitably apportioned share of the depletion allowance, in accordance with Section 611(b)(1) of the Internal Revenue Code of 1954, and its predecessor statutory provisions.

Petitioner's preoccupation with terminability prefers form over substance. The leases in the cases cited by Petitioner were executed before *Whitmer* (1969) and *Mullins* (1967) were decided by the Tax Court. Before then, no court applied the seven (7) mining contractor criteria to mineral leases. Those cases held that a mining lease containing a 30-day or 60-day termination provision failed to provide the taxpayer with an economic interest in the mineral in place. Prior to that time, terminability was not an issue in mineral leases. Since then, the Tax Court, in 1979, ruled that 120-day termination without cause is not fatal to the lessee under a mineral lease for percentage depletion purposes. Consequently, by merely changing the termination provisions to at least

120 days the lessees assure themselves of their right to percentage depletion allowance under Petitioner's argument. Congress, in enacting percentage depletion allowance, certainly did not intend that this artificial expedient, terminability, decide a lessee's entitlement to percentage depletion allowance, particularly if his lease is not terminated. Instead, the "economic interest" test hinges on whether the taxpayer has (1) acquired by investment an interest in the mineral in place and (2)whether he looks to the income from the extraction of the minerals for a return of his investment. *Paragon Jewel, supra; Southwest Exploration, supra; Weaver, supra.* Swank satisfied these requirements 6-13, *supra.*

C. Only Swank is entitled to percentage depletion and if denied this Congressional entitlement, no other person including lessor, would be entitled to percentage depletion with respect to the coal mined by Swank.

Petitioner at page 22 of the Brief for the United States attacks the position of the Respondent and the opinions of the Court of Claims adopting Respondent's position, by misstating the Court of Claims' opinions in *Bakertown* and this case. The *Bakertown* Court determined that a major factor entitling a similar lessee to percentage depletion was that "unless plaintiffs prevail, no one will be entitled to or receive any *percentage* depletion allowance on the coal removed from the land during the years at issue." 202 Ct.Cl. at 857, 485 F.2d at 642. (Emphasis added).

The Court of Claims in the instant cases stated:

> "Finally, we reiterate what was said in *Bakertown,* 485 F.2d at 642, 202 Ct.Cl. at 857, about the non-availability in these cases of the depletion allowance to the lessors or anyone else. If plaintiffs

> are not entitled, there will be no depletion on the coal mined under these leases" _____Ct.Cl. at _____, 602 F.2d at 351.

Obviously, the *Swank* Court in reiterating its *Bakertown* view was referring to *percentage* depletion, not cost depletion.

What both Courts said is absolutely true and correct as a statement of the results obtaining if the Petitioner's position were to be adopted.

Petitioner confuses cost depletion with percentage depletion, in addition to misstating the *Bakertown* Court's conclusion that only the lessee is entitled to percentage depletion.[9] This case and *Bakertown* involve the lessee's entitlement to percentage depletion, not cost depletion. Under Section 631(c) of the Internal Revenue Code of 1954, as amended, the lessor is not entitled to percentage depletion, but is allowed capital gains treatment on rents and royalties received and must use cost depletion in computing the capital gains. 26 U.S.C. §631(c).

The lessee receives percentage depletion only if he sells the coal which he mines. Mining with out sale is not sufficient, since percentage depletion is based on gross income received from the coal, exclusive of rents or royalties paid by the lessee. 26 U.S.C. §613(a). The lessee's income from the sale of the coal is treated as ordinary income. The lessor's income from rents or royalties paid by the lessee is treated as capital gain, but the lessor must claim cost depletion instead of percentage depletion. 26 U.S.C. §§613, 631(c).

Cost depletion differs materially from percentage depletion. Compare, 26 U.S.C. §611 and 612 with §613.

---

[9] Petitioner's brief at 9, 22-23.

Unlike cost depletion, percentage depletion is not related to the taxpayer's basis in the coal. 26 U.S.C. §612. Percentage depletion is "a fixed percentage of gross income which Congress allows to be excluded; . . . bears little relationship to the capital investment and the taxpayer is *not* limited to a recoupment of his original investment." *Southwest Exploration,* 350 U.S. at 312 (Emphasis added). The *Southwest* Court also noted that the percentage depletion allowance "continues so long as minerals are extracted, and even though no money was actually invested in the deposit." 350 U.S. at 312. In this context, the *Bakertown* Court observed, properly, as follows:

> "Unless plaintiffs prevail, no one will be entitled to or will receive any percentage depletion allowance on the coal removed from the land during the years at issue. Under the express terms of Section 631(c) of the 1954 Code, the lessors are 'relegated to capital gains treatment of the royalties received.' *Paragon Coal Co.* v. *Commissioner, supra,* at 636. None of the independent contractors has made a claim for a percentage depletion allowance and, if they made such claims, the terms of their contracts with plaintiffs would preclude them from entitlement to such allowances."

Accordingly, under Section 631(c) of the Internal Revenue Code of 1954, as amended, and the case law, the lessors at bar are not entitled to percentage depletion allowance. They are limited to the cost depletion allowance and capital gains treatment of their rental and royalty income.

Only the lessees are entitled to the percentage depletion allowance which is deducted from their ordinary income derived from the sale of the coal. If Swank is denied this deduction for percentage depletion, no one in the chain of those involved receives the deduction,

and the Congressional intendment that there be allowed a percentage depletion deduction to one party involved in the extraction and sale of the coal is thwarted.

CONCLUSION

For the foregoing reasons, the judgment of the United States Court of Claims must be affirmed and Respondents must be awarded their costs.

Respectfully submitted,

LLOYD R. PERSUN
HOWELL C. METTE
SHEARER, METTE &
WOODSIDE

September, 1980